Bloomberg BNA

Tax Management Memorandum™

Reproduced with permission from Tax Management Memorandum, 57 TM Memorandum 23, 1/25/16.
Copyright © 2016 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Altera: Rattling the IRS's Sense of Comfort in Its Rulemaking Process

By Susan E. Seabrook, Shareholder, and
Caroline C. Setliffe, Counsel
Buchanan Ingersoll & Rooney PC[*]
Washington, D.C.

If we knew what it was we were doing, it would not be called research, would it?
— Albert Einstein

EXECUTIVE SUMMARY AND OVERVIEW

In *Altera v. Commissioner*,[1] the Tax Court invalidated regulations promulgated by the U.S. Department of the Treasury (''Treasury'') under §482[2] that required participants entering into qualified cost sharing arrangements (''QCSAs'')[3] to include stock-based compensation (''SBC'') costs in the shared cost pool. The case has received considerable attention in part because it has been viewed as providing clarity in connection with two long-standing and thorny federal tax issues, one procedural in nature and the other substantive. This article explores the parameters of the Tax Court's holdings in connection with the two issues in order to assess the case's precedential impact upon each of them individually.

As discussed in more detail below, the Internal Revenue Service (the ''IRS'') takes the position that most of its regulations are interpretive, and thus the notice and comment provisions of §533(b) of the Administrative Procedure Act (''APA'') do not apply.[4] Notwithstanding the purported lack of a notice and comment requirement, the IRS's position is that its interpretative regulations have the force of law.[5] The Tax Court clarified in *Altera* that agency rules having the force of law are subject to §533(b) of the APA.

The Tax Court held that the transfer pricing regulation at issue (the ''Final Rule'') constituted a legislative rule, and not an interpretative rule, because the Final Rule was intended to, and did, have the force of law.[6] Because Treasury did not find for good cause that notice and comment were impracticable, unnecessary, or contrary to the public interest, §533(b) notice and comment provisions of the APA apply to the final rule. The court went on to explain that the standard of review (that is, *State Farm*[7] versus *Chevron*[8]) is immaterial because *Chevron* step 2 incorporates the

---

[*] Susan Seabrook's tax planning and controversy advice to clients integrates practical and strategic considerations with technical tax analysis, and is informed by her experience as an IRS litigator and her subsequent role as the IRS National Office's insurance industry tax counsel.

Caroline Setliffe's tax controversy practice focuses on best practices for IRS examinations and creative approaches to resolving tax controversies efficiently. Drawing on her experience as a former attorney advisor at the U.S. Tax Court, Caroline works to achieve client goals through strong communication skills, substantive and procedural expertise, and innovative, resolution-oriented strategies.

[1] 145 T.C. No. 3 (2015).

[2] Unless otherwise specified, all ''Section'' or ''§'' references refer to the Internal Revenue Code, as amended, and the regulations thereunder.

[3] The term ''qualified cost sharing arrangement'' or ''QCSA'' is defined by Reg. §1.482-7 to refer to cost sharing arrangements between related parties that meet the requirements of the regulation. Although unrelated parties do not technically enter into a ''qualified'' cost sharing arrangement, ''QCSA'' is sometimes used for convenience.

[4] IRM 32.1.2.3(3) (09-23-2011). Both the proposed and final versions of the regulation at issue state: ''It has [also] been determined that section 533(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.''

[5] IRM 32.1.5.4.7.5.1(10) (09-30-2011).

[6] The Commissioner agreed that the rule had the force of law, but disagreed with Altera's contention that the rule was a legislative rule. The court noted in its opinion that the Commissioner ''declined to argue this issue on brief or at oral argument.'' *Altera*, 145 T.C. No. 3, at 41 (slip. op.).

[7] *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43 (1983).

reasoned decisionmaking standard of *State Farm*. In applying the reasoned decisionmaking standard to the facts of the case, the Tax Court determined that Treasury did not satisfy its obligations under the notice and comment provisions of the APA in issuing the Final Rule.

With respect to the substantive issue, the question is whether, in connection with the development of intangibles, a cost sharing arrangement between controlled parties must include SBC in the pool of shared costs. The IRS has long (and unsuccessfully) argued that all costs means that SBC costs must be included in the shared cost pool.[9] Taxpayers, on the other hand, have maintained that uncontrolled parties do not share SBC costs in connection with comparable transactions and therefore SBC costs should be excluded from the shared cost pool. In 2005, the Tax Court decided the *Xilinx* case in favor of the taxpayer, finding that because unrelated parties would not share SBC costs, the Commissioner's imposition of such a requirement in connection with controlled party transactions was inconsistent with Reg. §1.482-1. The Ninth Circuit ultimately agreed with the Tax Court and affirmed.[10]

The legislative history to Congress's 1986 revisions to §482, which added the ''commensurate with income'' standard in connection with the transfer of hard to value intangibles, indicates support for the use of cost sharing arrangements by controlled parties in such situations ''if and to the extent'' such arrangements are consistent with the purpose of the legislation.[11] The Tax Court in *Altera* referenced *Xilinx*[12] for the proposition that ''the arm's-length standard always requires an analysis of what unrelated entities do under comparable circumstances.''[13] Therein lies the rub. It is difficult, if not impossible, to read the pair of regulations — Reg. §1.482-1(b)(1) and §1.482-7(d)(3) — as harmonious given the evidence that uncontrolled parties do not share SBC costs. Thus, the larger substantive question is whether any method that requires assumptions that do not reflect what unrelated parties actually do can ever produce an arm's length result. In *Altera*, the Commissioner argued that it is the ***result*** of the application of the method that must reflect arm's length ***pricing***, and that Treasury need not take into account evidence of uncontrolled party agreements in promulgating transfer pricing methods.[14] In connection with QCSAs, at least, the IRS's philosophy on this point has been soundly rejected by the courts.

Although the opinion in *Altera* touches on the above substantive question, the Tax Court does not need to tackle the issue head-on, and does not reach this substantive query in light of the procedural missteps by Treasury in promulgating the Final Rule.[15]

KEY ASPECTS OF THE LITIGATION

> ***The legal system is often a mystery, and we, its priests, preside over rituals baffling to everyday citizens.***
>
> ***— Henry Miller***

Ambrose Bierce famously defined litigation as ''[a] machine which you go into as a pig and come out of as a sausage.''[16] For the parties involved in the litigation, the matter generally concludes when the final decision is rendered by the court. For practitioners, however, our awareness of the matter often begins with the publication of the decision. At times, a case can take on a life of its own — public discourse shapes our views on what the case stands for, its significance, and how and why the court reached its conclusions. In contrast, when we are seeking to better understand a Code section and how it might apply to a set of circumstances, we may look to the legislative history for clues. If we're struggling with a Treasury regulation, we'll pull up the preamble to gain insight on Treasury and the IRS's thinking.

Tax cases may not have the equivalent of legislative history or a preamble, but a forensic survey of the procedural and evidentiary record in a tax case can nonetheless prove useful in evaluating the outcome. With respect to litigation in the Tax Court, the statutory notice of deficiency, the taxpayer's petition, and the Commissioner's answer generally define the parameters of the battleground. The stipulation of facts and any evidence entered at trial comprise the record.

---

[8] *Chevron USA, Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

[9] *See Seagate Technology, Inc. v. Commissioner*, T.C. Memo 2000-388 (IRS *argued* SBC costs must be included under 1968 version of the transfer pricing regulations); *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), *aff'g* 125 T.C. 37 (2005) (IRS *argued* that SBC costs must be included under 1995 version of the transfer pricing regulations).

[10] *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), *aff'g* 125 T.C. 37 (2005).

[11] H.R. Conf. Rep. No. 99-841 (Vol. II), at II-637 through II-638 (1986), 1986-3 C.B. (Vol. 4) 1, 637-638.

[12] *Xilinx*, 598 F.3d 1191.

[13] *Altera*, 145 T.C. No. 3, at 45 (slip. op.).

[14] *See Respondent's Reply Memorandum*, filed September 9, 2013; Action on Decision AOD-126401-10, I.R.B. 2010-33.

[15] The court notes that the Commissioner ''counters that Treasury should be permitted to issue regulations modifying — or even abandoning — the arm's-length standard. But the preamble to the final rule does not justify the final rule on the basis of any modification or abandonment of the arm's-length standard, and respondent concedes that the purpose of section 482 is to achieve tax parity.'' *Altera*, 145 T.C. No. 3, at 45–46 (slip. op.).

[16] *The Devil's Dictionary,* Ambrose Bierce.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

The parties' briefs and oral argument before the court describe the outcome each party seeks and provide the parties' strongest arguments supporting their right to that outcome.

In *Altera*, the parties apparently had differing views regarding what factors would drive the resolution of the dispute, as demonstrated by the IRS's significant factual concessions. The parties had starkly different views regarding the specifics of the application of the APA to the Final Rule. They disagreed on whether, assuming the notice and comment provisions of the APA applied to the Final Rule, Treasury satisfied the notice and comment provisions, and disagreed on the standard of review to be applied to make that determination. Finally, they disagreed on whether the Final Rule was consistent with the arm's length standard.

The factual record was fully stipulated, and the parties filed cross-motions for partial summary judgment. Petitioner's motion urged the court to invalidate the Final Rule. Respondent's motion asked the court to determine whether the Final Rule required petitioner to include SBC costs in the shared cost pool with respect to petitioner's QCSA. Petitioner's motion was granted, and respondent's motion was denied. In order to evaluate the parties' arguments and strategic choices, and evaluate the impact of each on the court's holdings, the discussion below will highlight some of the relevant aspects of the factual record before the court and the procedural posture.

THE ADMINISTRATIVE PROCEDURE ACT

Learning never exhausts the mind.

— Leonardo da Vinci

In the 1940's, Congress enacted the APA[17] in an effort "to improve the administration of justice by prescribing fair administrative procedure."[18] Congress codified the APA in two separate groups of provisions at 5 U.S.C. §551–§559[19] and §701–§706.[20] APA §551–§559 set forth general definitions relevant to the APA, contain statutory construction rules, and establish procedures applicable to administrative agencies. By contrast, APA §701–§706 relate to judicial review of both agency rulemaking and adjudicative actions.

Section 553 of the APA prescribes several procedural requirements in an effort to assist agencies to promulgate more rational, accurate rules by exposing the rulemaking process to criticism from interested commentators and stakeholders.[21] According to the Senate Judiciary Committee Report, "[agency] knowledge is rarely complete, and [the agency] must always learn the . . . viewpoints of those whom its regulations will affect. . . .[P]ublic participation . . .in the rulemaking process is essential in order to permit administrative agencies to inform themselves."[22] The risk of inaccuracy could result if a rule is complex or far-reaching, thus Congress thought it was imperative that the agency consider all available comments to ensure accuracy. In this connection, the Supreme Court has noted that "[i]n enacting the APA, Congress made a judgment that notions of fairness and informed administrative decisionmaking require that agency decisions be made only after affording interested persons notice and an opportunity to comment."[23]

Legislative Rules and Regulations

Regulations may be issued under a specific or general grant of authority from Congress. With respect to tax regulations, the consolidated return rules under §1502 are often referenced as an example of rules promulgated pursuant to a specific grant of authority. Section 7805 provides the Secretary a general grant of authority to promulgate rules and regulations under the Code. The IRS and Treasury have historically taken the position that all regulations promulgated under §7805 are "interpretative" regulations.[24] The APA distinguishes between "legislative" and "interpretive" rules and regulations by excluding interpretive rules from certain of the APA's procedural requirements, as discussed in more detail below.

The distinction between legislative and interpretive is important because, in order to have the "force of

[17] *Administrative Procedure Act*, Pub. L. No. 79-404, 60 Stat. 237 (1946).

[18] Senate Comm. on the Judiciary, *Administrative Procedure Act: Report of the Committee on the Judiciary*, S. Rep. No. 752, 79th Cong., 1st Sess. 7 (1945), reprinted in Legislative History of the Administrative Procedure Act, S. Doc. No. 248, 79th Cong., 2d Sess. 1, 187 (1946). Hereinafter "Administrative Procedure Act: Legislative History, S. Doc. No. 248."

[19] Subchapter II of Chapter 5 of Title 5 of the U.S. Code.

[20] Chapter 7 of Title 5 of the U.S. Code.

[21] Administrative Procedure Act: Legislative History, S. Doc. No. 248, at 19–20, 200–01, 358–59. *See also* Attorney General's Comm. on Administrative Procedure, *Final Report on Administrative Procedure in Government Agencies*, S. Doc. No. 8, 77th Cong., 1st Sess. 101–02 (1941).

[22] Administrative Procedure Act: Legislative History, S. Doc. No. 248, at 20.

[23] *See Chrysler Corp. v. Brown*, 441 U.S. 281, 316 (1979).

[24] 5 U.S.C. §553(b)(A). The statute refers to "interpretative" rules, which, according to *Fowler's Modern English Usage*, is the "right form" of the word. *See Fowler's Modern English Usage*, edited by Sir Ernest Gowers (2nd ed.), Great Britain: Oxford University Press. Commentators tend to use the term "interpretive," as did the Tax Court in *Altera*, noting in a footnote that "the terms 'legislative' and 'interpretive' have different meanings in the administrative law context." Hereinafter, for simplicity, we will refer to the common use of the term.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

law,'' agency rules and regulations must satisfy the procedural requirements of §553 of the APA. Substantive (or legislative) rules ''create rights, impose obligations or effect a change in existing law,''[25] thus the APA requires that the issuance of final legislative regulations be preceded by a notice and comment process to provide an opportunity for open dialogue with the public, and most importantly for the agency to receive feedback from that portion of the public that will be directly affected by the proposed rule.

The requirement under §553 to provide the public with adequate notice of a proposed rule is generally achieved through the publication of a notice of proposed rulemaking (''NPRM'') in the Federal Register[26] that offers interested parties an opportunity to submit written comments in response. The APA requires that the NPRM include ''(1) the time, place, and nature of public rulemaking proceedings; (2) reference to the legal authority under which the rule is proposed; and (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.''[27] The notice requirement of §553 is satisfied when the agency ''affords interested persons a reasonable and meaningful opportunity to participate in the rulemaking process.''[28]

Once the comment period has closed, the APA directs the agency to consider the ''relevant matter presented'' and incorporate into the adopted rule a ''concise general statement'' of the ''basis and purpose'' of the final rule.[29] The general statement of basis and purpose should ''enable the public to obtain a general idea of the purpose of, and a statement of the basic justification for, the rules.''[30] Because final rules must be a ''logical outgrowth'' of the preceding NPRM, an agency that ultimately shifts its analysis concerning a critical element of a proposed rule must consider and comment upon the change as well. In other words, a final rule is a logical outgrowth if affected parties should have anticipated that the relevant modification in the final rule was possible from the published proposed rule. Historically, courts have insisted that the preamble to final regulations articulate the agency's response to all significant comments received.[31] Finally, the APA requires an agency to publish its final regulations in the Federal Register 30 days before their effective date. The standard remedy for regulations that fail to satisfy these requirements is invalidation.

Rules Exempted from Notice and Comment Provisions

''Interpretive'' rules — along with general statements of policy and rules of agency organization, procedure, or practice — are exempted from the notice and comment provisions of the APA.[32] In addition, the notice and comments provisions of the APA may be bypassed when the agency for good cause finds that provisions are ''impracticable, unnecessary, or contrary to the public interest.''[33] In that event, the agency must incorporate that finding and a brief statement of reasons therefor in the rules issued.[34] The reason interpretive rules are exempted is because interpretive rules merely explain preexisting substantive law.[35]

Note, however, the legislative history of the APA states:

> Agencies are given discretion to dispense with notice (and consequently with public proceedings) in the case of interpretative rules, general statements of policy, or rules of agency organization, procedure or practice. This does not mean, however, that agencies should not — where useful to them or helpful to the public — undertake public procedures in connection with such rule making.[36]

JUDICIAL REVIEW STANDARDS

> ***I am always ready to learn although I do not always like being taught.***
>
> ***— Winston Churchill***

---

[25] *See Hemp Indus. Ass'n v. DEA*, 333 F.3d 1082, 1087 (9th Cir. 2003).

[26] 5 U.S.C. §553(b).

[27] 5 U.S.C. §553(b)(1)–§553(b)(3).

[28] *See, e.g., Forester v. Consumer Product Safety Commission*, 559 F.2d 774, 787 (D.C. Cir. 1977).

[29] 5 U.S.C. §553(c).

[30] Administrative Procedure Act: Legislative History, S. Doc. No. 248, at 225.

[31] *See, e.g., United States v. Nova Scotia Food Prod. Corp.*, 568 F.2d 240, 252 (2d Cir. 1977) (''It is not in keeping with the rational process to leave vital questions, raised by comments which are of cogent materiality, completely unanswered.'').

[32] 5 U.S.C. §553(b)(A).

[33] 5 U.S.C. §553(b)(B).

[34] *Id.*

[35] *See Hemp Indus. Ass'n v. DEA*, 333 F.3d 1082, 1087 (9th Cir. 2003).

[36] Senate Comm. on the Judiciary, *Administrative Procedure Act: Report of the Committee on the Judiciary*, S. Rep. No. 752 at 200.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

State Farm Review — Judicial Review of Agency Decisionmaking

Sections 701 through 706 of the APA contain various rules concerning judicial review of agency action.[37] Section 706(2) of the APA lists six standards for such review. One of those standards of review is that a court must set aside agency action that is ''arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.''[38] In *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co.*,[39] the Supreme Court explained that review under this ''standard is narrow and a court is not to substitute its judgment for that of the agency.'' Moreover, the Supreme Court explained that an agency must have ''engaged in reasoned decisionmaking,'' which means ''the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.' ''[40] In reviewing an agency action, a court must determine ''whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.''[41]

> Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[42]

Chevron Review — Judicial Review of Agency Statutory Construction

When a substantive challenge is asserted, courts traditionally give deference to agency interpretations. *National Muffler Dealers Assn. v. United States*,[43] provided the standard applicable to tax regulations from 1979 to 2011. Under the *National Muffler* standard, the amount of deference accorded to a Treasury regulation varied depending on various factors, requiring a court to examine the history of the regulation to determine whether it merited judicial deference:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent reenactments of the statute.[44]

After 1984, the *National Muffler* standard of deference was an exception to the generally applicable standard created in *Chevron USA Inc. v. Natural Resources Defense Council, Inc.*[45] The standard articulated in the *Chevron* case is a two-step test under which a court reviews an agency's authoritative construction of a statute. Entirely absent from *Chevron's* two-part test is any inquiry into the motivations for and history of the challenged regulation. Under *Chevron* step 1, a court must ask first whether Congress has directly addressed the precise issue in dispute. ''[A]pplying the ordinary tools of statutory construction,''[46] a court must determine ''whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.''[47] Under *Chevron* step 2, a court must defer to the agency's authoritative interpretation of an ambiguous statute ''unless it is 'arbitrary or capricious in substance, or manifestly contrary to the statute.' ''[48] In this second step, the regulation need not be the best interpretation, but only a reasonable one.

---

[37] 5 U.S.C. §551–§559, 701–06.

[38] §706(2)(A).

[39] *State Farm*, 463 U.S. 29, 43 (1983); *see also Judulang v. Holder*, 132 S. Ct. 476, 483 (2011); *Citizens to Pres. Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971), *abrogated on other grounds by Califano v. Sanders*, 430 U.S. 99 (1977).

[40] *State Farm*, 463 U.S. at 43 (*quoting Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)).

[41] *Id.* (*quoting Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc.*, 419 U.S. 281, 285 (1974)); *see also Judulang*, 132 S. Ct. at 484.

[42] *State Farm*, 463 U.S. at 43.

[43] 440 U.S. 472 (1979).

[44] *National Muffler*, 440 U.S. at 477.

[45] 467 U.S. 837 (1984).

[46] *City of Arlington v. FCC*, 133 S. Ct. 1863, 1868 (2013).

[47] *Chevron*, 467 U.S. at 842–843.

[48] *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 53 (2011) (*quoting Household Credit Servs., Inc. v. Pfennig*, 541 U.S. 232, 242 (2004)); *see also Judulang*, 132 S. Ct. at 483 n. 7.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

Moreover, the *Chevron* case made clear that there may be more than one ''permissible construction'' of a statutory provision that a reviewing court is required to accept, under *Chevron* step 2, if the construction is adopted by an agency. In this regard, a permissible agency interpretation of a statutory provision must be accepted under step 2 by a court reviewing the agency's interpretation, even if the agency's interpretation is not the interpretation the court would have adopted based on its own analysis:

> The court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding.[49]

REJECTION OF TAX EXCEPTIONALISM

> ***1913 wasn't a very good year.***
>
> ***1913 gave us the income tax, the 16th amendment and the IRS.***
>
> ***— Ron Paul***

For many years, the tax community along with courts treated tax agencies differently from other administrative agencies vis a vis the application of certain principles of administrative law. This treatment became known as ''tax exceptionalism.'' In *Mayo Found. for Med. Educ. & Research v. United States*,[50] the Supreme Court rejected tax exceptionalism, holding that the general administrative law standards articulated in *United States v. Mead Corp.*,[51] and *Chevron*[52] govern judicial review of Treasury regulations.[53] In *Mayo*, the Court admonished, ''we are not inclined to carve out an approach to administrative review good for tax law only.''[54] As the *Mayo* Court explained, ''[f]illing gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes.''[55]

For years prior to *Mayo*, the courts and the tax community had debated whether the standard in *Chevron* or *National Muffler* provided the appropriate standard of review for evaluating general authority Treasury regulations. The *National Muffler* standard expressly called for considering an interpretation's consistency and longevity — factors that weighed against Treasury's new regulation — while the *Chevron* standard expressly recognized the need to allow agencies to change their interpretive positions.

The *Mayo* case involved a recurring dispute between the IRS and the medical community over whether medical residents are ''students'' and are therefore exempt from FICA taxation. After losing several cases, Treasury issued new regulations providing that any full-time employee (including any employee who works more than 40 hours a week) cannot qualify for the student exemption from FICA.[56] The Mayo Foundation brought litigation asserting that the regulation was invalid. The district court agreed and struck down the regulation.[57] The Eighth Circuit, however, reversed the district court and reinstated the regulation.[58] The Mayo Foundation, along with numerous amici from the medical community, appealed to the Supreme Court, which granted certiorari.

The Supreme Court concluded that the definition of a ''student'' in the FICA student exemption was ambiguous. However, in light of conflicting precedents in *National Muffler* and *Chevron*, it was not clear which standard the Court should apply after concluding that the statutory text was ambiguous. The Supreme Court recognized the conflict inherent in these two standards and found that *National Muffler* and *Chevron* ''call for different analyses of an ambiguous statute.''[59] Under *National Muffler*, ''a court might view an agency's interpretation of a statute with heightened skepticism when it has not been consistent over time, when it was promulgated years after the relevant statute was enacted, or because of the way in which the regulation evolved.''[60] It might also find relevant ''that the regulation had been promulgated after an adverse judicial decision.''[61]

First, the Supreme Court made clear that, under *Chevron*, ''deference to an agency's interpretation of an ambiguous statute interpretation does not turn on such considerations.''[62] Hence, Treasury regulations produced through ''notice-and-comment'' rulemaking must be reviewed under the two-step framework articulated in *Chevron* rather than the alternative framework described in *National Muffler*.

---

[49] *Chevron*, 467 U.S. at 843 n.11 (citations omitted).

[50] 562 U.S. 44 (2011).

[51] 533 U.S. 218 (2001).

[52] *Chevron*, 467 U.S. at 837.

[53] *Mayo Found.*, 562 U.S. at 45–46.

[54] *Mayo Found.*, 562 U.S. at 55.

[55] *Mayo Found.*, 562 U.S. at 45.

[56] Reg. §31.3121(b)(10)-2(d)(3)(iii).

[57] 503 F. Supp. 2d 1164 (D. Minn. 2007).

[58] 568 F.3d 675 (8th Cir. 2009).

[59] *Mayo Found.*, 562 U.S. at 54.

[60] *Id.* at 54.

[61] *Id.* at 54–55.

[62] *Id.* at 55.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

Second, the Court held that for purposes of applying *Chevron* to Treasury regulations, it is immaterial whether the regulation was promulgated under a specific grant of authority from Congress or Treasury's general authority under §7805(a) to ''prescribe all needful rules and regulations for the enforcement'' of the Code. Such regulations carry the force of law, and the Code imposes penalties for failing to follow them. As the Court explained, the level of deference afforded to a regulation ''does not turn on whether Congress's delegation of authority was general or specific.''[63] Thus, although the Supreme Court in *Mayo* did not address the legislative versus interpretive characterization of general authority Treasury regulations, the Court summarily rejected the specific versus general authority distinction in determining whether such regulations carry the force of law for *Chevron* purposes.

NATURE AND HISTORY OF THE TRANSFER PRICING DISPUTE

> ***If you have ten thousand regulations you destroy all respect for the law.***
>
> ***— Winston Churchill***

Congress authorized the Secretary of the Treasury to allocate income and deductions among related business entities to prevent tax avoidance. Section 482 thus permits the IRS to allocate income, deductions, and other items between commonly controlled parties where such an allocation is necessary to clearly reflect the income of the parties:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. . . .

The purpose of §482 is to ensure that taxpayers clearly reflect the income attributable to controlled transactions, and to prevent tax avoidance with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.

Regulations promulgated under §482 ''set[s] forth general principles and guidelines to be followed under §482.''[64] The regulations provide that the standard to be employed ''in every case'' to ensure taxpayers accurately reflect income from controlled transactions is an arm's length standard:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.[65]

Thus, Reg. §1.482-1(b)(1) mandates that the true taxable income of controlled parties is determined by reference to how parties operating at arm's length would behave. The language of the regulation is unequivocal: the arm's length standard applies ''in every case.''

In 1986, Congress amended §482 to provide:

> In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.[66]

Congress enacted this amendment to §482 in response to concerns regarding the acknowledged lack of comparable arm's length transactions, particularly in the context of high-profit potential intangibles. In enacting this amendment, however, Congress did not intend to preclude the use of bona fide cost sharing arrangements (as defined under longstanding regulations) under which related parties that share the cost of developing intangibles in proportion to expected

[63] *Mayo Found.*, 562 U.S. at 57.

[64] Reg. §1.482-1(a)(1).

[65] Reg. §1.482-1(b)(1).

[66] Tax Reform Act of 1986, Pub. L. No. 99-514, §1231(e), 100 Stat. at 2562.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

benefits have the right to separately exploit such intangibles free of any royalty obligation.[67]

Treasury issued detailed new cost sharing regulations in 1995 that generally authorized the IRS ''to make each controlled participant's share of the costs . . . of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development.'' In *Xilinx Inc. v. Commissioner*,[68] the taxpayer challenged proposed deficiencies based on the Commissioner's determination that the taxpayer should have included the value of certain employee stock options (''ESOs,'' a type of SBC) in the intangible development cost pool, relying on the 1995 cost sharing regulations.

In reviewing the record, the Tax Court found Treasury's files lacked any expert opinions, empirical data, published or unpublished articles, papers, surveys, or reporting that supported a determination that the amounts attributable to SBC must be included in the cost pool of QCSAs to achieve an arm's length result. Furthermore, the Tax Court found that there was no evidence that Treasury had searched any database that could have contained agreements between unrelated parties relating to joint undertakings or the provision of services, nor that Treasury was aware of any written contract between unrelated parties that required one party to pay or reimburse the other party for amounts attributable to SBC. Also lacking was any evidence of any actual transaction between unrelated parties in which one party paid or reimbursed the other party for amounts attributable to SBC. Although the preamble to the final regulations responded to certain comments, there was no justification for any modification or abandonment of the arm's length standard. The Tax Court held that under the 1995 cost sharing regulations, controlled entities entering into QCSAs need not share ESO costs because parties operating at arm's length would not do so.

The case was appealed, and the Ninth Circuit wrestled with the issue of whether the more specific regulation (''all costs'') should trump the general (the arm's length method must be used in ''every case''). The court ultimately reasoned that the term ''costs'' did not include ESOs because that interpretation would not comport with the ''dominant purpose'' of the transfer pricing regulations as a whole.[69] In affirming the decision of the Tax Court, the Ninth Circuit held that the ''all costs'' requirement should not be construed to apply to ESO costs because the regulations should be interpreted to accomplish the statutory purpose of grounding the IRS's allocation authority in the principle of ''parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions.''

After the case was docketed, but prior to the issuance of the Tax Court's opinion in *Xilinx*, Treasury proposed amendments in 2002 to the 1995 cost sharing regulations in an effort to:

- Clarify that SBC must be taken into account in determining operating expenses under Reg. §1.482-7(d)(1),
- Provide rules for measuring SBC costs, and
- Include express provisions to coordinate the cost sharing rules of Reg. §1.482-7 with the arm's length standard of Reg. §1.482-1.

Thus, the amended regulations explicitly address the interaction between the arm's length standard and the cost sharing rules, and the treatment of SBC in the cost sharing context. Reg. §1.482-1(b)(2)(i) now states that ''§1.482-7 provides the specific methods to be used to evaluate whether a cost sharing arrangement . . . produces results consistent with an arm's-length result.'' In turn, Reg. §1.482-7(d)(2), as amended, specifically identifies SBC as a cost that must be shared.

Treasury issued final regulations in 2003 consistent with the proposed regulations, explicitly requiring parties to QCSAs to share SBC costs, contrary to the views expressed by commentators. Many of the commentators informed Treasury that they knew of no transactions between unrelated parties, including any cost sharing arrangement, service agreement, or other contract, that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation. Additionally, several commentators identified arm's length agreements in which SBC was not shared or reimbursed. The Final Rule also added regulations providing that QCSAs produce an arm's length result only if the parties' costs are determined in accordance with the Final Rule.

ALTERA TAX COURT DECISION: REVIEW OF THE RECORD

> ***Those who cannot remember the past are condemned to repeat it.***
>
> ***— George Santayana — Reason in Common Sense, p. 284, Volume 1 of The Life of Reason***

[67] H.R. Conf. Rep. No. 99-841 (Vol. II), at II-637–II-638 (1986), 1986-3 C.B. (Vol. 4), 1, 637–638.

[68] 125 T.C. 37 (2005).

[69] 598 F.3d 1191 (9th Cir. 2010).

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

On May 22, 2013, the parties in *Altera* electronically filed a Stipulation of Facts[70] with the Tax Court. The points that follow include relevant portions of the Stipulation of Facts. This exercise is useful because it more explicitly illustrates the factual record the court had to work with in issuing its opinion.

Background Facts

With some minor modifications, the parties stipulated to most of the background facts alleged by Altera in its petition.

- Altera US is a Delaware corporation headquartered in San Jose, California and the publicly held parent company of a group of U.S. and foreign companies (collectively, ''the Altera Group''), including Altera International, Inc., a Cayman Islands Company (''Altera International'').[71]

- The Altera Group develops, manufactures, markets, and sells programmable logic devices (''PLDs'') and related hardware, software, and pre-defined design building blocks known as intellectual property cores for use in programming the PLDs (''Programming Tools'').[72]

- Altera Corporation & Subsidiaries (the ''Petitioner'' or ''Altera'') is an affiliated group of corporations that timely filed consolidated Federal income tax returns on Forms 1120, U.S. Corporation Income Tax Returns, for its taxable years ended December 31, 2004, December 30, 2005, December 29, 2006, and December 28, 2007 (collectively, the ''years at issue'').[73]

- Effective May 23, 1997, Altera US and Altera International entered into a Master Technology License Agreement (the ''Technology License Agreement'').[74]

- Pursuant to the Technology License Agreement, Altera US licensed to Altera International the right to use and exploit all of the intangible property of Altera US relating to PLDs and Programming Tools that existed prior to the cost sharing agreement (collectively, the ''Pre-Cost Sharing Intangible Property''), in all parts of the world with the exception of the United States and Canada.[75]

- Altera US retained the right to use and exploit the Pre-Cost Sharing Intangible Property in the United States and Canada.[76]

- In exchange for the rights granted pursuant to the Technology License Agreement, Altera International paid royalties to Altera US in each year from 1997 through 2003.[77]

- As of December 31, 2003, Altera International owned a fully paid up license to use the Pre-Cost Sharing Intangible Property in its territory.[78]

- Concurrently with the Technology License Agreement, effective as of May 23, 1997, Altera US and Altera International entered into a Technology Research and Development Cost Sharing Agreement, pursuant to which they agreed to pool their respective resources to conduct research and development with respect to PLDs using the Pre-Cost Sharing Intangible Property.[79]

- This agreement was amended and restated effective December 27, 1997, to extend the scope of the agreement to include research and development with respect to Programming Tools (the ''Cost Sharing Agreement'').[80]

- The Cost Sharing Agreement was continuously in effect from May 23, 1997, through 2007[81] and contained a number of provisions pursuant to which Altera US and Altera International agreed to do the following:
  - Share the risks and costs of research and development activities performed on or after May 23, 1997;[82]
  - Divide beneficial ownership of intangible property developed under the cost sharing arrangement in their respective territories[83]

- Altera International had all rights, interests, and beneficial ownership of all intangible property developed under the Cost Sharing Agreement for

---

[70] *Altera Corporation & Subsidiaries v. Commissioner of the Internal Revenue*, *Stipulation of Facts* (May 22, 2013), hereinafter ''*Stipulation of Facts*.''

[71] *Stipulation of Facts* at ¶8.

[72] *Stipulation of Facts* at ¶9.

[73] *Stipulation of Facts* at ¶1 and ¶4.

[74] *Stipulation of Facts* at ¶12.

[75] *Stipulation of Facts* at ¶13

[76] *Stipulation of Facts* at ¶14.

[77] *Stipulation of Facts* at ¶15.

[78] *Stipulation of Facts* at ¶15.

[79] *Stipulation of Facts* at ¶16.

[80] *Stipulation of Facts* at ¶16.

[81] *Stipulation of Facts* at ¶17.

[82] *Stipulation of Facts* at ¶19.

[83] *Stipulation of Facts* at ¶20.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

exploitation in all parts of the world with the exception of the United States and Canada;[84]

- Altera US had all rights, interests, and beneficial ownership of all intangible property developed under the Cost Sharing Agreement for exploitation in the United States and Canada.[85]

- During each taxable year from 2004 through 2007, Altera US granted stock options and other stock-based compensation to certain of its employees. Certain of the employees of Altera US who performed research and development activities subject to the Cost Sharing Agreement received stock options or other stock-based compensation. The employees' cash compensation was included in the cost pool under the Cost Sharing Agreement, whereas their stock-based compensation was not. Under the Cost Sharing Agreement, Altera International paid to Altera US cost sharing payments for its 2004 through 2007 taxable years in the following amounts:[86]

Year	Cost Sharing Payments
2004	$ 129,469,233
2005	$ 160,722,953
2006	$ 164,836,577
2007	$ 192,755,438

- For each of Altera's 2004, 2005, 2006, and 2007 taxable years, Altera US and Altera International did not include any amount relating to stock-based compensation in the cost pool of research and development expenses to be shared pursuant to the Cost Sharing Agreement for purposes of determining the amount of the cost sharing payment from Altera International to Altera US under the Cost Sharing Agreement.[87]

Issue-Focused Stipulations

In addition to background facts specific to Altera, the stipulation comprehensively covered the circumstances surrounding Treasury's regulatory process in connection with the Final Rule. The stipulations served essentially as admissions by the IRS of many of the allegations of fact in Altera's petition that addressed these points, although the Commissioner in most cases reserved an objection on the grounds of relevancy.

The stipulations and the corresponding objections are consistent with the IRS and Treasury's view that (i) §533(b) notice and comment provisions of the APA do not apply to interpretative regulations; (ii) *Chevron* deference applies to a review of such rules and merely requires that the Final Rule represent a permissible construction of §482; and (iii) a transfer pricing method that produces an arm's length result need not be consistent with the actual practices of uncontrolled parties. The stipulations establish that:

- The Commissioner exercised his discretion under §482 to allocate income from Altera International to Altera US and to increase Altera International's cost sharing payments for 2004, 2005, 2006, and 2007, respectively, **solely to bring Altera into compliance with Reg. §1.482-7 (2003).**[88]

- At the time the 2002 Notice of Proposed Rulemaking was issued, Treasury and the Commissioner had not identified, were not aware of, and did not have in their possession any written contract between unrelated parties in a cost sharing arrangement that required one party to pay or reimburse the other party for amounts attributable to SBC, nor had they identified, were aware of, or have in their possession any written cost sharing agreement, services agreement, or other contract between unrelated parties that required one party to pay or reimburse the other party for amounts attributable to SBC.[89]

- In advance of the promulgation of the Final Rule, several commentators informed Treasury and the Commissioner that they knew of no evidence of transactions in which unrelated parties agreed to share amounts attributable to SBC, and further informed Treasury and the Commissioner that unrelated parties did not agree to share amounts attributable to SBC in contracts with the U.S. government.[90]

- In adopting the Final Rule, it was the position of Treasury and the Commissioner that the process of developing Treasury Regulations, and the files documenting the process, are not and do not reflect fact finding or evidence gathering procedures.
- The files maintained by Treasury and the Commissioner relating to the Final Rule did not contain any empirical data that supports the position that amounts attributable to SBC must be included in the cost pool of QCSAs to achieve an arm's length result.
- The files maintained by Treasury and the Commissioner relating to the Final Rule did not con-

[84] *Stipulation of Facts* at ¶21.
[85] *Stipulation of Facts* at ¶22.
[86] *Stipulation of Facts* at ¶24.
[87] *Stipulation of Facts* at ¶28.
[88] *Stipulation of Facts* at ¶29.
[89] *Stipulation of Facts* at ¶36, ¶37.
[90] *Stipulation of Facts* at ¶41–¶43.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

tain any expert opinions or any published or unpublished articles or papers, surveys, or reports, and did not have any record suggesting that a search of any database that could have contained agreements between unrelated parties had been performed.

At the time Treasury and the Commissioner issued the Final Rule, they did not have any evidence of any actual transaction between unrelated parties in a cost sharing arrangement in which one party paid or reimbursed the other party for amounts attributable to SBC.[91]

[91] *Stipulation of Facts* at ¶58–¶63.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

THE APA ACCORDING TO THE INTERNAL REVENUE MANUAL

> ***He who learns but does not think, is lost!***
>
> ***He who thinks but does not learn is in great danger.***
>
> ***— Confucius***

Despite gathering momentum of precedent to the contrary, Treasury and the IRS continue to take the position that the majority of the regulations they promulgate do not require notice and comment because the requirements of §553(b) of the APA for notice and comment rulemaking do not apply to guidance issued pursuant to §7805(a), the provision that grants the Secretary authority to develop ''all needful rules and regulations for the enforcement of'' the Internal Revenue Code. Stated differently, Treasury and the IRS regard regulations promulgated under the general authority of §7805(a) as interpretive rather than legislative and thus deem them exempt from the notice and comment procedures. However, in the same stroke Treasury and the IRS also assert that these regulations have the force of law and are therefore entitled to *Chevron* deference.

Interesting enough, the record and the Tax Court's opinion in *Altera* do not offer a complete picture of the IRS's view concerning the application of the APA to the agency's rulemaking process in this case. The Tax Court notes:

> Respondent agrees that the final rule has the force of law but disagrees with petitioner's contention that it is a legislative rule. However, respondent declined to argue this issue on brief or at oral argument.
>
> Instead, respondent contends we need not decide this issue because Treasury complied with the notice and comment requirements.[92]

It is somewhat unusual for a litigant to stipulate to his opponents' alleged facts and then decline to address certain potentially related legal arguments on brief or at oral argument. A quick overview of the relevant provisions of the Internal Revenue Manual may shed some light on the IRS's views on the application of the APA:

> **32.1.5.4.7.5.1 (09-30-2011)**
>
> **Administrative Procedure Act**
>
> (1) The Administrative Procedure Act (APA) generally requires agencies that promulgate rules to provide public notice of a proposed rulemaking in the Federal Register, permit the public to submit written comments, and include a general statement of the rule's basis and purpose when publishing the final rule. 5 U.S.C. §553(b), (c). Regulations required to follow the APA's notice and comment procedure are referred to as legislative rules or substantive rules.
>
> (a) The APA excepts from these requirements interpretative rules, general statements of policy, and rules of agency organization, procedure, or practice. 5 U.S.C. §553(b)(A).

* * * * *

32.1.1.2.6 (09-23-2011)

Interpretative Regulations

(1) The Administrative Procedure Act (APA) exempts interpretative rules from the APA's notice and comment requirements. Generally, rules or statements issued by an agency to advise the public of the agency's construction of the statutes it administers are considered interpretative. ***Most IRS/Treasury regulations are considered interpretative because the underlying statute implemented by the regulation contains the necessary legal authority for the action taken and any effect of the regulation flows directly from that statute.*** See CCDM 32.1.1.2.7 and CCDM 32.1.1.2.8, below, and *CCDM 32.1.5.4.7.5.1(2)*, Administrative Procedure Act, for further discussion on whether a regulation is interpretive or legislative. (Emphasis added.)

32.1.1.2.7 (09-23-2011)

Legislative Regulations

(1) Regulations required to follow the APA's notice and comment procedure are referred to as legislative rules or substantive rules. Legislative rules are required when Congress simply provided an end result, without any guidance as to how to achieve the desired goal or when a statutory provision does not provide adequate authority for the regulatory action taken.

32.1.1.2.8 (09-23-2011)

How to Determine If a Rule Is Interpretative or Legislative

(1) Whether a regulation is promulgated under a specific grant of authority in the Internal Revenue Code does not govern whether the regulation is interpretative or legislative.

(2) If Congress simply provided end result, without any guidance as to how to achieve

[92] *Altera*, 145 T.C. No. 3, at 41 (slip. op.).

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

the desired goal, then regulations promulgated to achieve that goal are considered to be legislative.

(3) If Congress provided specific rules and merely left gaps for the Secretary to fill, regulations filling those gaps are considered interpretative.

(4) If the regulation repeats law subsumed in the underlying legislation, then the regulation is considered interpretative.

* * * * *

THE *ALTERA* FIGHT, IN A NUTSHELL

Meteorologist see perfect in strange things, and the meshing of three completely independent weather systems to form a hundred-year event is one of them. My God, thought Case, this is the perfect storm.

— Sebastian Junger, The Perfect Storm: A True Story of Men Against the Sea

Keeping in mind the factual foundation for the Tax Court's consideration of the issues, and the then-current state of the applicable law, we turn to consideration of exactly what the *Altera* fight is about.

The central substantive issue in the *Altera* case was whether the IRS's proposed reallocation of SBC costs by applying the Final Rule of Reg. §1.482-7, as adopted in 2003, to Altera U.S.'s research and development QCSA with Altera International was consistent with the ''arm's-length'' standard prescribed by Reg. §1.482-1(b)(1). Altera argued that significant amounts of empirical data supported the conclusion that unrelated parties would *not* include SBC as a cost in any cost sharing arrangement, thus the allocation proposed by the IRS would violate the arm's length standard that applies ''in every case'' in determining the true taxable income of a taxpayer. The Commissioner argued that, *by definition*, a QCSA produces an arm's length result and thus clearly reflects income *only* if all the requirements of Reg. §1.482-7 are met, including the sharing of SBC costs.[93]

The theme of the case that emerges from Altera's arguments is that Treasury fashioned a rule that includes SBC as a cost that applies to every controlled taxpayer, in the face of overwhelming evidence that no example could be found in which uncontrolled taxpayers shared such a cost. Altera leveraged this position with strong procedural arguments directed at Treasury's lack of meaningful observance of the requirements of the APA. Focusing on the fact that the allocation proposed by the IRS was not consistent with the practices of uncontrolled parties, Altera argued that the IRS's interpretation is not reasonable because it disregards actual uncontrolled transactions, and is therefore inconsistent with the purpose of §482, which is to place controlled parties on parity with uncontrolled parties through application of the arm's length standard. Further, §482's ''commensurate with income'' clause does not supplant the arm's length standard, which continues to apply in every case.

Altera argued that the Final Rule is not entitled to deference because Treasury did not base its findings on the evidentiary record, and in fact rejected the empirical data provided to it. The fact that Altera chose to structure its agreement to fit the QCSA criteria did not mean Altera forfeited the application of the parity standard of §482. Finally, Altera argued that the IRS could not save the Final Rule by characterizing SBC as an economic cost.

The essence of the Commissioner's case was that the application of the ''method'' prescribed by Reg. §1.482-7 produced an arm's length result. This outcome-oriented position apparently absolved the IRS and Treasury of any potential APA ''sins,'' because the IRS took the position that it need not prove that actual cost sharing arrangements between unrelated parties included sharing the costs of SBC. The Tax Court ultimately disagreed with the IRS, and phrased the issue in the case as whether the provision in the Final Rule requiring that the cost of SBC be included in the costs that are shared in order to achieve an arm's length result is arbitrary and capricious and therefore invalid.

THE TAX COURT OPINION

Common sense is genius dressed in its working clothes.

— Ralph Waldo Emerson

The Tax Court opinion in *Altera* was a reviewed opinion authored by Judge Marvel and unanimously agreed to by all other judges who participated in the review. The case came before the court on the parties' cross-motions for partial summary judgment. Recall that, in addition to the background factual stipulations summarized above, the parties' stipulation also covered items that proved to be key factors in the ultimate outcome:

- The Commissioner's allocations at issue rest solely on the application of Reg. §1.482-7 to Altera's cost sharing arrangements;
- The Commissioner's allocations were not based on any actual transactions between unrelated parties;

[93] *Memorandum in Support of Respondent's Motion for Partial Summary Judgment*, V.C.2.a.1., at 44.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

- The Commissioner's allocations were not based on any evidence of what unrelated parties bargaining at arm's length would have done in the same cost sharing transaction; and
- Treasury's promulgation of the rule under Reg. §1.482-7 was not based on a review or analysis of any available evidence related to the conduct of uncontrolled parties in similar circumstances.

The Tax Court opinion covered much of the same historical background as covered above in connection with §482, the application of the APA to tax regulations, and the evolution of the dispute regarding the inclusion of SBC costs in connection with QCSAs.

The Tax Court undertook a detailed review of the applicable principles of administrative law, including the notice and comment procedures required under APA for informal agency rulemaking. The court noted that while the notice and comment requirements generally do not apply to interpretive rules, which merely explain preexisting substantive law, the requirements do apply where the rule is intended to have the force of law. Substantive (or legislative) rules by contrast, ''create rights, impose obligations, or effect a change in existing law.'' A rule has the force of law ''only if Congress has delegated legislative power to the agency and if the agency intended to exercise that power in promulgating the rule.''[94]

The Tax Court concluded that the regulations at issue were a legislative rule for purposes of §533(b) of the APA based on the language of §7805(a) stating that the Secretary is authorized to ''prescribe all needful rules and regulations for the enforcement of'' the Code, and reasoned that ''[s]uch regulations carry the force of law, and the Code imposes penalties for failing to follow them.''[95] The court further observed that Treasury intended for the Final Rule to have the force of law for the following reasons: (1) the parties stipulated that the adjustments to Altera's income could be sustained only on the basis of the Final Rule, and (2) in promulgating the Final Rule Treasury invoked its general legislative rulemaking authority under §7805(a).

In response to Altera's contentions that the Final Rule should be reviewed under *State Farm* and the Commissioner's contention that *Chevron* should apply, the court concluded that the ultimate standard of review was ''immaterial'' based on its determination that *Chevron* step 2 incorporates *State Farm*'s reasoned decisionmaking standard. The court proceeded to analyze whether the final rule satisfied this *State Farm* standard.

[94] *Altera*, 145 T.C. No. 3, at 34 (slip. op.).

[95] *Id.* at 42.

The Tax Court agreed with Altera's arguments that the Final Rule was invalid under the reasoned decisionmaking standard because:

1. The Final Rule ***lacked a basis in fact***;
2. Treasury ***failed to rationally connect*** the choice it made with the facts it found;
3. Treasury ***failed to respond*** to significant comments; and
4. The Final Rule was ***contrary to the evidence*** before Treasury.

The court found that the Final Rule ***lacked a basis in fact*** because Treasury issued the Final Rule without any evidence that unrelated parties would ever agree to share SBC costs. In doing so, the Tax Court summarily rejected the Commissioner's contentions that: (a) Treasury did not rely solely on its belief that unrelated parties entering into cost sharing arrangements would generally share SBC costs but that it also relied on the commensurate with income standard; and (b) Treasury was sufficiently experienced with cost sharing arrangements to conclude that unrelated parties entering into cost sharing arrangements would generally share SBC costs. The court further justified its conclusion that the Final Rule lacked a basis in fact by observing that Treasury failed to engage in any fact finding and, therefore, failed to examine the relevant data, and that Treasury failed to support its purported belief that unrelated parties would share SBC costs in the context of a cost sharing arrangement with any evidence in the record.

The court went on to find that Treasury ***failed to rationally connect*** the choice it made with the facts it relied upon, and rejected the claim made in the preamble to the Final Rule that Treasury relied on its belief that unrelated parties entering into cost sharing arrangements to develop high-profit intangibles would share SBC costs if the SBC was a significant element of the compensation. Of significance to the court was the fact that the Commissioner did not dispute Altera's argument that (1) many QCSAs do not deal with high-profit intangibles and (2) SBC is often not a significant element of the compensation of the employees of taxpayers that enter into QCSAs.

The court further determined that Treasury ***failed to respond*** to significant comments submitted by national accounting firms, trade associations, and economists. Such comments and evidence were similar to the evidence submitted in *Xilinx*, and included a trade association member survey that showed no arm's length co-development and joint venture agreements in which the parties agreed to share SBC costs, searches of the EDGAR system finding no cost sharing agreements between unrelated parties in which the

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

parties agreed to share either the exercise spread or grant date value of SBC, as well as identification of actual arm's length agreements in which SBC costs were not shared or reimbursed.

In reviewing the evidence provided to Treasury, the court determined that Treasury's conclusion that the Final Rule was consistent with the arm's length standard was ***contrary to all of the evidence*** before it. The court stated: "Significantly, Treasury never said that it found any of the submitted evidence incredible. Treasury also seemed to accept the commentators' economic analyses, which concluded that — and explained why — unrelated parties to a QCSA would be unwilling to share the exercise spread or grant date value of stock-based compensation. Finally, respondent has not identified any evidence in the administrative record that supports Treasury's belief that unrelated parties to QCSAs would generally share stock-based compensation costs."[96] As a result, the court determined that the Final Rule was invalid because Treasury engaged in arbitrary and capricious decision-making.

In conclusion, the court rejected the Commissioner's Hail Mary argument that the APA "harmless error" provision was applicable, reasoning that it was "not clear that Treasury would have adopted the Final Rule had it concluded that the Final Rule is inconsistent with the arm's-length standard."

IMPLICATIONS OF ALTERA AND BEYOND

> ***The present contains nothing more than the past, and what is found in the effect was already in the cause.***
>
> ***— Henri Bergson***

Would *Altera* have been decided differently had Treasury thoroughly explained its position in the preamble? The question necessarily begs the answer, *"yes!"* understanding that there are a number of possible hypothetical outcomes to that scenario. The IRS appears to be constrained in its ability to make effective arguments under the circumstances. Treasury can promulgate transfer pricing rules that are not inconsistent with actual uncontrolled party conduct and that satisfy the arm's length standard. Treasury cannot promulgate transfer pricing rules that explicitly reject the evidence concerning comparable uncontrolled transactions while denying that they are doing so. The unanswered larger question concerns whether Treasury can abandon the arm's length standard in promulgating transfer pricing rules under §482. In *Altera*, the IRS arguments contained an answer to that question, and it was in the affirmative.[97]

As we know, the Tax Court did not reach the issue of whether the Final Rule as drafted might have been upheld if Treasury had instead provided a more thorough explication of their reasoning — the facts relied upon and the relationship of those facts to the rule promulgated. The key question is whether there could possibly be a satisfactory explanation for dismissing empirical data regarding the practices of uncontrolled parties — for in essence abandoning the touchstone of the arm's length standard. Would it be sufficient for Treasury to simply say SBC costs must be included because they serve as an economic proxy for some other pricing factor and thus the inclusion is necessary in order to produce an arm's length result? If not, has *Altera* perhaps paved the way for challenges to other transfer pricing rules that incorporate inconsistencies with controlled party transactions?

Turning to the title of this paper, the decision in *Altera* underscores the IRS's false sense of comfort in the rulemaking process. Many practitioners perceived the *Mayo* decision as foreclosing, for practical purposes, the possibility of future successful challenges to Treasury tax regulations. However, the *Altera* decision adds a layer of complexity under circumstances in which the regulation requires an empirical analysis, and thus is necessarily based on a factual determination. Mere belief as to what unrelated parties generally would do was not enough for the Tax Court.[98]

The implications of the *Altera* decision go beyond transfer pricing regulations to put into question the historical approach taken by Treasury in promulgating all tax regulations. It is now clear that tax regulations intended to have the force and effect of law are subject to the notice and comment requirements of the APA. *Altera* also clarifies for the record the scope and depth of the notice and comment requirements in the context of tax regulations — no different than for any other agency's rules.

Most importantly, *Altera* clarifies that regulations issued under the Treasury's general rulemaking authority under §7805(a) are indeed legislative rules because they are intended to have the force of law. Thus, whether tax regulations are issued under a specific grant of authority or under the general authority of §7805(a), as in the *Altera* case, they are subject to the notice and comment rulemaking process outlined in APA §533(b). Altera's counsel succinctly summarized

[96] *Id.* at 66.

[97] "Respondent counters that Treasury should be permitted to issue regulations modifying — or even abandoning — the arm's-length standard." *Altera*, 145 T.C. No. 3, at 45 (slip. op.).

[98] 68 Fed. Reg. at 51,173.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295

the inherent flaw in the Commissioner's approach — "the Commissioner puts the cart before the horse. He is not entitled to any presumption under *Chevron* and *Mayo* until he establishes that he adhered to the rules for notice-and-comment rulemaking."[99]

Although Treasury and the IRS have a great deal of expertise, they are not in a position to know it all. At a very minimum, the *Altera* decision should persuade Treasury not only to continue to engage in meaningful notice and comment proceedings for regulations, but in doing so to take that extra step to synthesize and assimilate responses to significant comments in the preamble to the regulations. The fatal flaw in this case was the fact that Treasury failed to respond to comments or even engage in its own independent fact-finding to reach the appropriate result. Stated differently, deference goes only so far.

From a litigation perspective, the *Altera* decision highlights the crucial role that stipulations play in Tax Court litigation. Rule 91 of the Tax Court Rules of Practice and Procedure requires that facts be stipulated to the "fullest extent to which complete or qualified agreement can or fairly should be reached. . ." The effect of this is that a stipulation is treated as a conclusive admission by the parties to the stipulation. The stipulation process provides Tax Court litigants a tremendous opportunity to prove much, if not all of their cases before trial. The most significant, and perhaps damaging, stipulation in *Altera* was the Commissioner's concession that "[i]n adopting the 2003 Final Cost Sharing Regulations, it was the position of Treasury and the Commissioner that in accordance with the Chief Counsel Directives Manual, the process of developing Treasury regulations, and the files documenting that process, are not and do not reflect fact finding or evidence gathering procedures."[100] The Commissioner's steadfast conviction that such fact finding was unnecessary and that he had "adopted a view that is well supported not only by its experience and expertise but by common sense"[101] was a conviction not shared by the Tax Court.

CONCLUSION

Power must never be trusted without a check.
— John Adams

On December 1, 2015, the Tax Court entered a final decision in *Altera*, however, it was vacated for revised computational adjustments and re-entered on December 28, 2015. Accordingly, the IRS has 90 days to file a notice of appeal from that decision. An appeal would reside in the Ninth Circuit, the same circuit that decided *Xilinx*. Even if the IRS does not appeal *Altera*, the fight is not yet over for the company. On December 18, 2015, Altera filed another petition in Tax Court challenging the IRS again on the issue of whether SBC costs must be included in QCSAs.[102] Although the challenge involves subsequent iterations of the transfer pricing regulations and the tax years involved are different, the arguments appear to be the same.

Commentators have speculated that the IRS may not file an appeal in *Altera*. Given the latest petition and the broader implications of continuing to press the case with this particular taxpayer, the IRS may instead be motivated to file an appeal, especially if there are not material differences in Treasury's approach to notice and comment with respect to the next generation of cost sharing regulations. If, however, the IRS can point to significant factual differences in Treasury's approach to notice and comment in connection with the subsequent regulations, the IRS may prefer to simply nonacquiesce with the Tax Court's legal assertions in *Altera* — conserve resources by litigating essentially the same case with a better set of facts. We'll just have to wait and see.

---

[99] *Petitioner's Brief in Opposition to Respondent's Motion for Partial Summary Judgment* at 7.

[100] *Stipulation of Facts* at ¶58.

[101] *Memorandum in Support of Respondent's Motion for Partial Summary Judgment* at 47.

[102] *Altera Corp. v. Commissioner*, T.C., No. 31538-15, *Petition filed December 18, 2015*.

© 2016 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0148-8295